

## California's GO Rating Lowered Three Notches to 'BBB'; Off CreditWatch

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DALLAS (Standard & Poor's) July 24, 2003—Standard & Poor's Ratings Services said today it lowered its rating on California's \$26.8 billion of state general fund-supported general obligation debt outstanding three notches, to 'BBB' from 'A', and lowered its rating on the state's \$6.7 billion of general fund lease-supported debt outstanding to 'BBB-' from 'A-'. The ratings have been removed from CreditWatch, where they had been placed July 2. Standard & Poor's also assigned its stable outlook to the debt.

The downgrade results from the lack of progress in adopting a fiscal 2004 budget, which has been aggravated by the gubernatorial recall election that has now been scheduled for Oct. 7, roughly three months into fiscal 2004. With political focus on the recall, the prospects for meaningful structural budget reform resulting from any enacted budget are diminished.

"A restoration of the rating would have to be preceded by the structural improvement of the state budget and progress toward the elimination of out-year deficits," said Standard & Poor's credit analyst Alexander M. Fraser.

Further credit deterioration in the short term is unlikely absent a severe cash flow crisis. To that end, Standard & Poor's recognizes that any efforts to head off a cash flow shortfall may be restricted by covenants in recent state note-related credit lines that limit additional cash flow borrowing, in the absence of a state budget, to maturities extending after those for the \$11 billion revenue anticipation warrants sold in June.

In addition, Standard & Poor's continues to recognize the potential for disruption of state operations and local entities dependent on state support—particularly community colleges, which cannot receive state aid in the absence of a budget. Last year, state budget adoption occurred in early September despite a smaller budget gap. Nevertheless, general obligation debt payments and debt service for state public works board general fund lease debt can still be paid in absence of a state budget under existing continuing budget resolutions.

Final budget resolution is currently hampered by state constitutional requirements for a two-thirds legislative majority and sharp differences of opinion in the legislature between the desire for tax increases and the avoidance of large budget cuts. The climate within the legislature has been affected by the large number of relatively new legislators due to term limits; the drawing of legislative districts that have intensified partisan differences; intensified lobbying by various interest groups; the possibility of challenges to the state's recent implementation of motor vehicle license fee tax rate increases; and the enormous magnitude of the state's \$38.2 billion projected accumulated budget gap, compared to fiscal 2003 total estimated general fund revenues of just \$67.8 billion.

Positive state credit features include a very deep and diverse economy; a rising, but still moderately low, debt burden; and a progressive income tax structure that could show strong revenue growth in good economic times, although now showing weakness during the current economic sluggishness.

California's 'BBB' rating is the lowest of the 50 states rated by Standard & Poor's.

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